VZCZCXYZ0013
PP RUEHWEB

DE RUEHMO #5428/01 3201445
ZNR UUUUU ZZH
P 161445Z NOV 07
FM AMEMBASSY MOSCOW
TO RUEHC/SECSTATE WASHDC PRIORITY 5308
INFO RUCPDOC/DEPT OF COMMERCE WASHDC PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RHEHNSC/NSC WASHDC PRIORITY

UNCLAS MOSCOW 005428

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STATE FOR EUR/RUS
TREASURY FOR TORGERSON
DOC FOR 4231/IEP/EUR/JBROUGHER
NSC FOR WARLICK AND MCKIBBEN

E.O. 12958: N/A
TAGS: ECON EFIN EIND RS
SUBJECT: RUSSIA'S BUSINESS COMMUNITY SEES MORE CONTINUATION THAN CHANGE

REF: MOSCOW 5373

¶1. (U) This message is sensitive but unclassified, and not for internet distribution.

Summary

¶2. (SBU) During the 4th Moscow Business Dialogue on November 12, government officials and business professionals forecast a general continuation of the current mix of market and statist economic policies after the end of Putin's term as president in March 2008. For instance, when asked what the country could expect after March 2008, Central Bank (CBR) First Deputy Chairman Aleksey Ulyukaev dryly replied, "April," indicating an expectation that GDP, investments, and consumption would continue to rise. There was, however, debate about the state,s role in the economy. Deputy Regional Development Minister Maksim Bystrov said the state would continue to be active in development projects. MDM Bank Chairman Oleg Vyugin and Deutsche Bank Chief Economist Yaroslav Lissovolik agreed that the economy would continue to grow regardless but argued that it would do better if the government interfered less and relied more on the markets. Finally, Ulyukaev indicated that monetary policy was shifting from supporting a strong ruble to fighting inflation through interest rates. End Summary.

No Major Changes Expected In Economic Course

¶3. (SBU) Speakers representing Russian business and the GOR at the 4th Moscow Business Dialogue said they did not expect major changes in Russia's economic course after the elections. President of the Russian Union of Industrialists and Entrepreneurs Aleksandr Shokhin expressed the conventional wisdom that "there is no doubt about United Russia's victory in December." The success of the Putin years had compelled most political parties "who hoped to reach the 7 percent threshhold (required for party representation in the Duma)" to embrace economic policy platforms reflecting the current course.

¶4. (SBU) According to Shokhin, only the "most radicalized parties such as the Communists" have excluded business community considerations from their proposals and agendas. The country's mid-term economic goals depended upon

implementing a long-term legislative strategy, which was expected to be approved in February 2008. Putin's leadership of United Russia would, therefore, put the Duma solidly behind a continuation of policies that have prevailed during the last eight years. Key initiatives on enhancing Russia's business climate currently before the Duma included amendments to tax and corporate governance legislation as well as passage of the Strategic Sectors Law.

¶5. (SBU) Deputy Central Bank (CBR) Chairman Aleksey Ulyukaev echoed Shokhin's sentiment that the post-election economy would continue to grow with few disruptions and decreasing imbalances. The Russian economy "broke the cycle of political dependence years ago." In the intervening period, Russia's fiscal prudence generated reserves to withstand external shocks to the economy. Since 1999, exports were the overwhelming driver of economic growth, "but domestic consumption became more important" in the last two years. Much of that consumption spurred increased foreign direct investment (FDI) and rising initial public offering (IPO) volumes placed domestically and abroad, which translated into "high marks for Russia's economy from foreign businesses." GOR officials put in place the necessary conditions to encourage these results and would probably undertake only minor changes to the current mix of economic policies.

State's Role and Common Sense

¶6. (SBU) Regional Development Deputy Minister Maksim Bystrov outlined how the GOR had incorporated its intermediate-term economic development strategy into the three-year budget. The multi-year budget represented an unprecedented initiative and major policy shift and built transparency into the GOR's spending priorities, creating predictability in its spending patterns. Consequently, this system of fiscal discipline would allow the state to continue playing an active role as an investor and co-investor in the country's economic growth.

¶7. (SBU) Bystrov said the state's role in the economy would continue through programs such as the Federal Venture Fund, Public-Private Partnerships (PPP), the Development Bank, the Concessions Law, and the various Special Economic Zones. Bystrov noted that programs such as Special Economic Zones had been criticized both as excessive and insufficient, but he argued the state had a role to spur greater diversification and could be expected to do so.

¶8. (SBU) MDM Bank Chairman of the Board, and former Federal Financial Markets Service Director, Oleg Vyugin sounded a more cautionary note, particularly where the state's role was concerned. He repeated a number of times that the GOR's role in Russia's economic development was not necessarily a bad thing, as long as it exercised "common sense." Some investment decisions the GOR should have made, such as in health care, education, and physical infrastructure, however, had been postponed. Now the GOR was trying to make up for lost time and favored leveraging public resources with private sector technology and know-how.

¶9. (SBU) In particular, Vyugin noted that infrastructure projects under the PPP framework have languished as a result of administrative delays or started much more slowly than anticipated. Russia would benefit from a more straight-forward rubric of "sponsoring" the business community's involvement in large-scale infrastructure and development projects. The current pace of investments, around 20 percent of GDP, was insufficient for Russia's needs and might be hindered under the PPP system, according to Vyugin.

¶10. (SBU) Despite having signed a "voluntary" price controls agreement covering eight food categories (reftel), President of food and beverage maker Wimm-Bill-Dann (WBD) David Yakobashvili maintained a strongly bullish outlook on Russia. He said he expected the Kremlin to continue to facilitate

the conditions in which Russian firms could thrive domestically and to work toward commonly applied standards, especially in the food sector, for Russian firms' success abroad. Increasing global demand for food in the last three years put a premium on efficiency for WBD and its suppliers. The GOR's market-oriented treatment of the food sector allowed WBD as well as its competitors to grow domestically and abroad. Yakobashvili explained that his firm understood the sensitivity of the food inflation issue and would probably extend its commitment under the price controls agreement into the spring 2008.

Inflation and the WTO

¶11. (SBU) Ulyukaev said that CBR monetary policy was shifting. The practice of managing ruble appreciation had outlived its usefulness as a means of controlling inflation and tended now to draw in "hot money" from abroad that was helping to further fuel inflation. Ulyukaev said he expected the CBR to liberalize ruble exchange rate policies and move toward using interest rates to control inflation. In addition, he said that in the wake of subprime mortgage concerns, Russia's banking sector had found new interest in acquiring short-term funds from the CBR at market rates. He said the CBR recognized that not all banks enjoyed equal access to this liquidity and would work toward smoothing this imbalance for large and small banks.

¶12. (SBU) In response to Ulyukaev, Vyugin said the economy would benefit from less focus on managing inflation through exchange rate levers. Sooner or later, ruble appreciation would occur and reduce Russia's trade surplus. According to Vyugin, a strong ruble would not necessarily hurt Russian firms' competitiveness. Instead, the strong ruble would allow Russian companies to upgrade their facilities and modernize production through cheaper foreign technology imports. Turning to the current GOR focus on rising food prices, Vyugin said that rising food prices were a global phenomenon and that there was little that could be done to stem price growth.

¶13. (SBU) Deutsche Bank Chief Economist Yaroslav Lissovolik said that Russia's private sector would benefit from more market-oriented governance like Ulyukaev described. The banking sector would experience growth if the Central Bank was focused on supplying and absorbing liquidity through interest rates levers. Russian firms would also benefit from the competition that Russia's membership in the WTO would provide. Lissovolik stressed that the Russian economy was at such a stage that it needed the discipline, and would reap development gains, that would come from membership. He added that Russia's accession might reinvigorate the stalled Doha round of negotiations and inject new thinking into the body.

Comment

¶14. (SBU) The speakers agreement that the current political cycle would not lead to a major change in Russia's economic policies comes as no surprise. However, what did come as a surprise at an event like this was the degree of debate over the state,s role in the economy. To the extent that Vyugin's view is representative of the broader private sector, it is clear that many are uncomfortable with the state's role, as presently conceived, in promoting economic development. If Russia is to successfully move to the next level in its economic development, in which growth should be less and less dependent on oil and gas exports, it will need to redefine the balance between its penchant for statist approaches in favor of the benefits of a market orientation. End Comment.
BURNS